LPL Financial

Rate and Credit View

A Normalization, Not a Crisis. Yet.

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Executive Summary

- The concerns in the Treasury market are real: a $40 trillion debt stock, deficits still tracking above $2 trillion, interest expense that is large enough to feed the deficit it is meant to service, inflation that has not returned to 2%, and a wave of AI-related corporate issuance that is competing for the same long-duration buyers.
- Those pressures explain why the long end has repriced. They do not, on the evidence we have today, add up to a buyers' strike, a dysfunctional auction calendar, or a disorderly market.
- Rate volatility is subdued. Coupon auctions cleared cleanly through the loudest week of the narrative. Market-implied inflation remains anchored near 2.3%. Term premium is rebuilding toward historically ordinary levels, not crisis levels.
- Calling every move higher in yields a crisis is the wrong framing, in our view. This is what a bond market looks like when the Federal Reserve (Fed) is neither a price-insensitive buyer nor a reliable provider of forward guidance.

Treasury Market Angst. Separating Noise from Signal

August delivered the loudest bond market narrative in years, and almost none of it survived contact with the price action.

Total public debt crossed $40 trillion on August 18. The 30-year Treasury reached 5.33% intra week, a level last seen in 2007. The move was global, with the German 10-year at 3.27% and the Japanese 10-year near 2.93%, both at or near multi-decade highs. The federal deficit is tracking north of $2 trillion. Treasury Secretary Scott Bessent intervened with an expanded buyback program. A new Fed chair delivered his first Jackson Hole keynote. Commentators reached, predictably, for bond vigilantes, buyers' strikes, and debt spirals.

Our view is that this is an uncomfortable but necessary normalization rather than a crisis. That distinction is not semantic hedging, and it is not hopeful optimism (we don't think). It is a claim about mechanisms, and it carries a specific, falsifiable test. In a normalization, higher yields recruit buyers. In a crisis, higher yields chase them away. Everything we observed in August points to the former.

But the concerns underneath the move are legitimate and dismissing them would be the wrong kind of contrarianism. We want to acknowledge them properly before explaining why we still think the market is functioning as designed. But, like Aesop's fable about a boy who cried wolf, calling every orderly selloff a crisis is unhelpful as it potentially desensitizes investors to the real crisis that may eventually come. We don't think we are there yet, but debt and deficit trajectories are unsustainable on this current path. Something will need to be done. The good news is we were in a similar situation in the 1990s and Congress acted. There are some similarities, but differences as well. We will take a closer look at what we can learn from that era in next month's *Rate and Credit View*.

Four Concerns Worth Taking Seriously

The debt and deficit arithmetic are real concerns
The Congressional Budget Office's (CBO) February baseline puts the FY2026 deficit at $1.9 trillion, or 5.8% of GDP, against a 50-year average of 3.8%. Actual receipts and outlays are tracking above that. Federal debt held by the public sits at roughly 101% of GDP and is projected to reach 120% by 2036, surpassing the 1946 record of 106%. Gross federal debt runs to $63.7 trillion by 2036, according to the CBO's projection.

The primary deficit, which excludes interest, is projected to decline from 2.6% of GDP to 2.1%. In other words, the deterioration in the fiscal path from here is almost entirely an interest expense story. The government's operating gap is stabilizing. Its financing costs are not. And unlike discretionary spending, Congress can't change these expenses with a vote.

Interest expense is the compounding problem, and the CBO's projection may be optimistic
Net interest reached roughly $1.0 trillion, or 3.3% of GDP, in FY2026. That eclipsed the 1991 record. The CBO projects it will double to $2.1 trillion, or 4.6% of GDP, by 2036. Interest already consumes about 19% of federal revenue and is projected to consume 26% by 2036. It exceeds defense spending every year of the outlook and surpasses Medicare by FY2028.

The overly optimistic part? The CBO's interest projections embed an interest rate assumption that the curve is already trading above. The February baseline assumed the 10-year Treasury would average 4.1% in 2026 and drift to 4.4% by 2031, holding there through the projection period. The 10-year closed August at 4.75%.

And the math isn't helpful. With roughly $32 trillion of debt held by the public, a sustained 50 basis point overshoot of the CBO's terminal assumption adds on the order of $160 billion per year to net interest once the stock fully turns over. Treasury's weighted average maturity is short enough that turnover happens faster than what's happened in the past. Since the U.S. doesn't pay its bills off, but rather refinances them, that $160 billion does not go away. It becomes deficit, which becomes issuance, which pressures yields.

This is the loop that gives the bearish case its teeth: higher yields raise interest expense, which widens the deficit, which increases supply, which pressures yields. In economic textbooks this is called fiscal primacy, which is the condition where fiscal policy, not monetary policy, sets the marginal price of duration. It is not fiscal dominance, in which the central bank is compelled to monetize deficits and abandons its inflation objective. The distinction matters enormously. Fiscal primacy is uncomfortable and expensive. Fiscal dominance is a currency crisis. We are firmly in the first regime, and Chair Warsh's Jackson Hole remarks made clear he has no intention of entering the second.

Inflation has stopped cooperating
The July Personal Consumption Expenditures Index (PCE) rose 0.2% month over month against expectations of 0.1%, reversing June's decline. Headline PCE is 3.7% year over year and core is 3.3%. Both are meaningfully above target. The Strait of Hormuz situation has kept an energy risk premium in the system all summer, and while crude has been more stable recently, the recurring headline cycle has not resolved.

The federal funds target range sits at 3.50% to 3.75%. The 2-year Treasury closed August at 4.33%. That gap of roughly 60 to 85 basis points is the market telling you it expects the next move to be a hike, not a cut. Following Warsh's Jackson Hole speech, September hike odds moved to roughly 70%, up from 31% earlier in the week. We still think the bar for a hike is higher than a Fed on hold, but the risk that the market will force Fed action is rising.

AI issuance is competing directly for the long-duration buyer
This is the newest of the four concerns and one we wrote about in the 2026 Midyear Outlook.

The five major hyperscalers issued roughly $28 billion to $35 billion of U.S. corporate bonds annually between 2020 and 2024. In 2025, that figure jumped to $108 billion. Through the first five months of 2026 alone, they issued $159 billion. S&P counts roughly $225 billion from hyperscalers and related issuers, including Nvidia, through July. Full-year estimates for the broader AI complex, extending to chipmakers, data center developers, and utilities, range from $300 billion to $570 billion.

The critical detail is not the volume. It is the tenor. Data centers have multi-decade useful lives, and issuers have matched their liabilities accordingly, including a century bond and Amazon's roughly $54 billion multi-tranche deal in March. Estimates suggest $300 billion of AI-related investment grade supply delivers something closer to $360 billion in 10-year duration equivalents.

That duration has to be absorbed by the same finite pool of buyers that absorbs Treasury duration: insurance, general accounts, pension plans running liability-driven mandates, and long-duration mutual funds. This is textbook crowding out, running in an unfamiliar direction. It is not the government crowding out private borrowers. It is private borrowers competing with the government for the marginal duration dollar.

The market structure is changing because of this as well. Technology now represents roughly 10% of the Bloomberg Corporate Bond Index and outweighs banks in several major investment grade benchmarks for the first time. Investors running passive core bond exposure have acquired unplanned hyperscaler concentration and unplanned long-dated tech duration. Hyperscaler spreads have already responded, with 5-to-7-year paper widening from roughly 50 to 60 basis points and 20-year-plus paper widening from 108.5 to 118 basis points. Of 91 hyperscaler bonds issued in 2026 with comparable pricing data, 78 were trading at higher yields in late July than at issue, with a median increase of about 22 basis points.

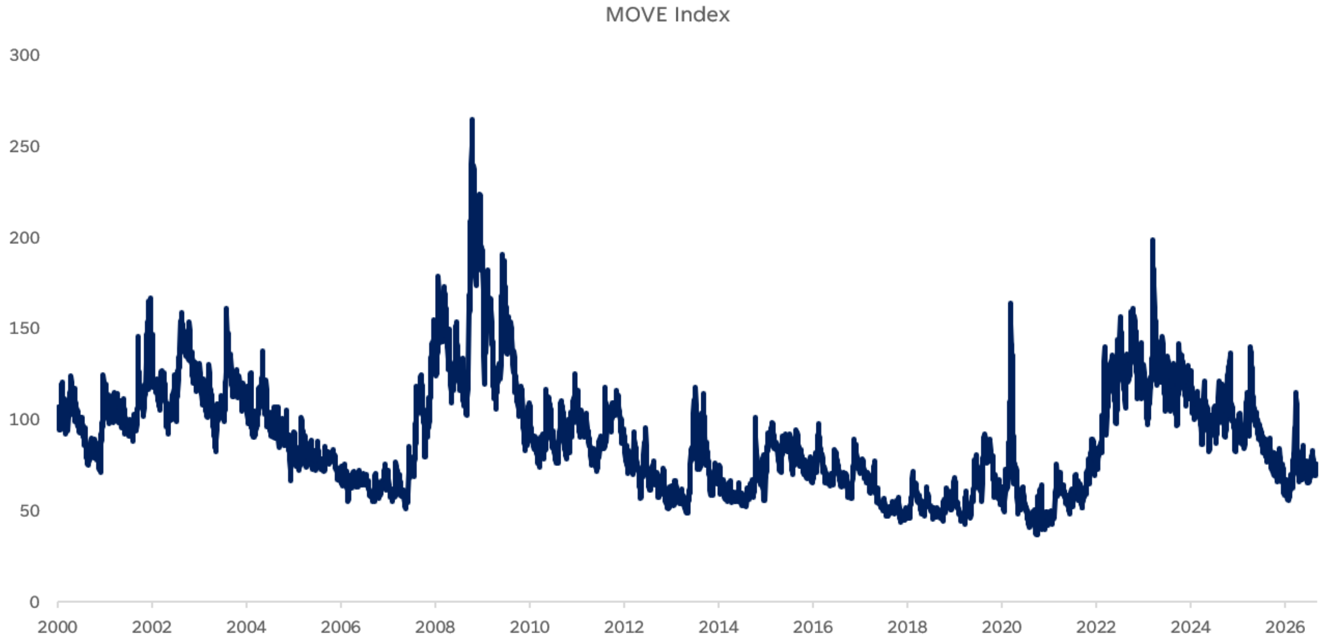
Why We Still Call This a Normalization

Four real concerns. Now the evidence that the market is absorbing them in an orderly fashion.

Implied rate volatility has refused to confirm the panic
The MOVE Index closed August in the high 60s to low 70s, having printed 69.58 on August 14, its lowest level of 2026. Its 52-week high is above 115. During the March 2023 regional banking episode, it approached 200.

The 30-year Treasury yield reached its highest level since 2007, the debt crossed $40 trillion, and a new Fed chair delivered an unscripted policy signal, all while options traders declined to pay up for protection against large yield moves. Implied volatility is the purest available measure of whether sophisticated investors believe the distribution of outcomes has widened. It says they do not.

Implied Volatility Remains Subdued



Source: LPL Research, Bloomberg 08/31/26
Disclosure: Past performance is no guarantee of future results.

The auctions did not merely clear, they cleared well
August's coupon calendar was the cleanest available test of the buyers' strike thesis, and it ran during peak hysteria.

Issue	Size	Stop yield	Bid-to-cover	Vs. recent avg.
2-year note (Aug 25)	$69 billion	4.204%	2.60x	2.62x average
5-year note (Aug 26)	$70 billion	4.393%	2.37x	2.34x average
7-year note (Aug 27)	$44 billion	4.512%	2.50x	2.49x average

That is $183 billion of coupon supply absorbed across three sessions. The seven-year is the tenor that tails when demand is genuinely impaired, because it sits in the awkward zone between the front-end money that buys 2s and 5s and the liability-driven money that buys 10s and 30s. It did not tail. Bid-to cover came in above average.

A buyers' strike has a recognizable signature: auctions that tail meaningfully through the when-issued level, primary dealer takedowns climbing above 25% as dealers absorb what nobody else wants, and indirect bidder participation falling sharply. We observed none of those. The market is not refusing to buy Treasuries. It is refusing to buy them at the old price, which is the entire function of a market. While we don’t want to put too much emphasis on one week of auctions, that it happened during a week when the noise was the loudest is a good, passing test for the market.

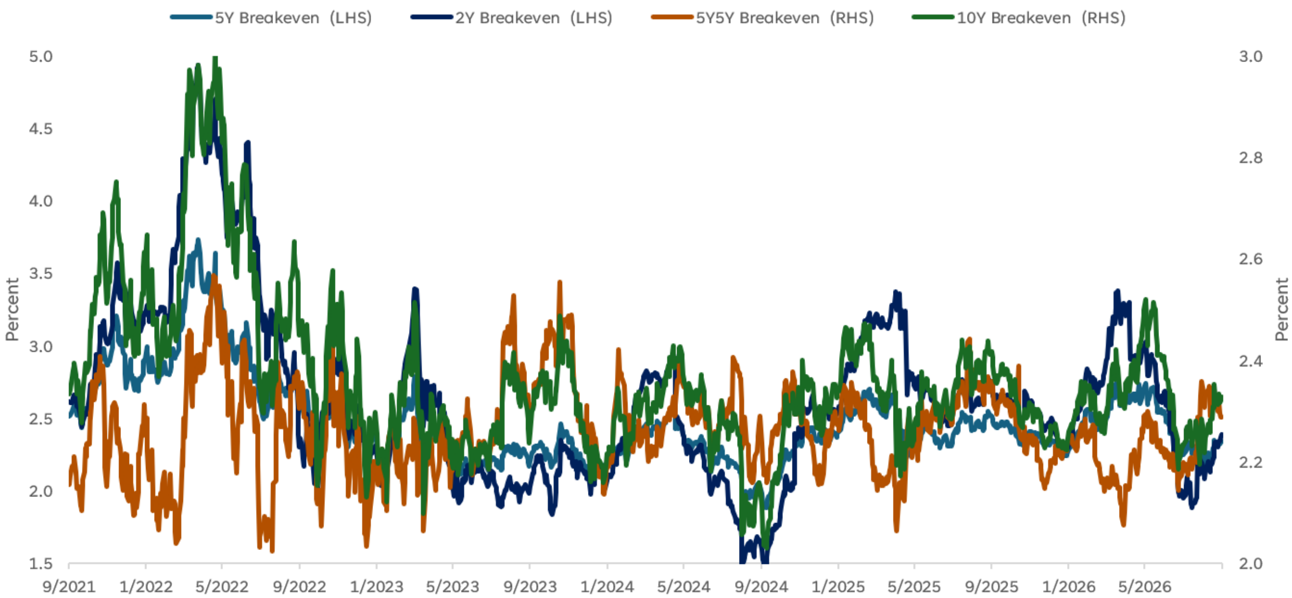
Inflation compensation compressed while nominal yields rose
This is the single most important chart and one we've referenced all year.

The five-year breakeven inflation rate closed August at around 2.32%. The 10-year breakeven was also near 2.32%, and the 20-year around 2.48%. The five-year, five-year forward rate, which strips out near-term energy noise and is the cleanest read on long-run expectations, sits near 2.30%.

The five-year breakeven traded at 2.53% to 2.56% as recently as March 2026. So, over a period in which the 10-year nominal yield rose toward 4.75% and the 30-year reached its highest level in nineteen years, market-implied inflation expectations went down.

As such, almost the entire backup in long nominal yields is real yield. It is compensation for duration risk, supply, and uncertainty about the policy path. It is not the market pricing an inflationary debasement of the currency. A genuine fiscal crisis of the kind being described in the headlines would show up first and most violently in long-dated breakevens and in the currency, because that is how markets price a government expected to inflate its way out. Breakevens are anchored inside the Fed's target range. That is not what a debt spiral looks like.

Market-Implied Inflation Expectations Remain Relatively Anchored



Source: LPL Research, Bloomberg 08/31/26
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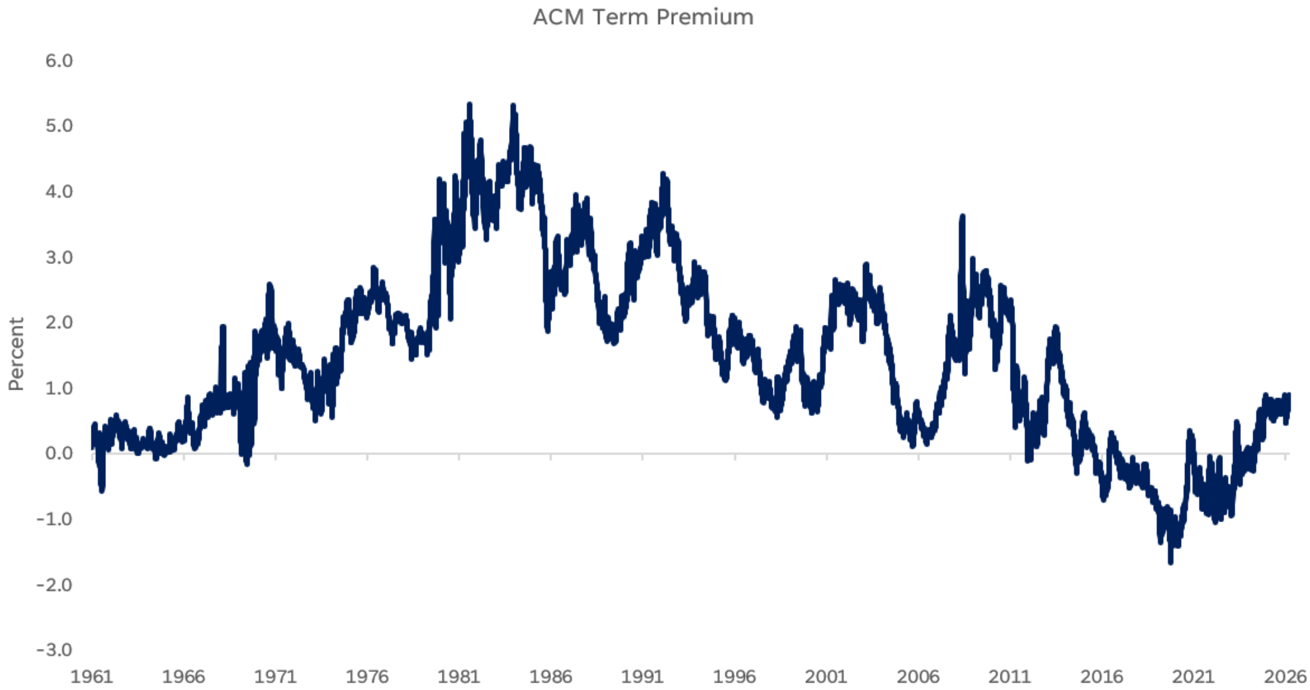
Term premium is rebuilding toward normal, not overshooting it
The New York Fed's Adrian, Crump, & Moench ACM model put the 10-year term premium at approximately 0.75% at August month end. The Fed's Board's Kim-Wright model had it at 0.87% on August 21. The two models correlate at 0.86 over their overlapping history and currently agree closely, which is a useful robustness check given that term premium estimates are model residuals and different specifications can disagree by 50 to 100 basis points.

The ACM series has averaged roughly 1.45% since 1961.

After the largest long-end repricing in years, after $40 trillion in debt and a $2 trillion deficit, term premium sits at roughly half of its six-decade average. It was negative for much of the 2016 to 2022 period, an artifact of quantitative easing and safe-haven demand that we should never have treated as the baseline. What we are witnessing is the unwinding of an anomaly, not the creation of one.

Moreover, the Fed has withdrawn twice: once as a price-insensitive buyer through quantitative easing, and again as a forward guidance provider under a chair who genuinely prefers to communicate less. Term premium was suppressed by both. Both are gone. The repricing is a market taking this into account.

Treasury Term Premium is Almost Back to Normal



Source: LPL Research, Bloomberg 08/31/26
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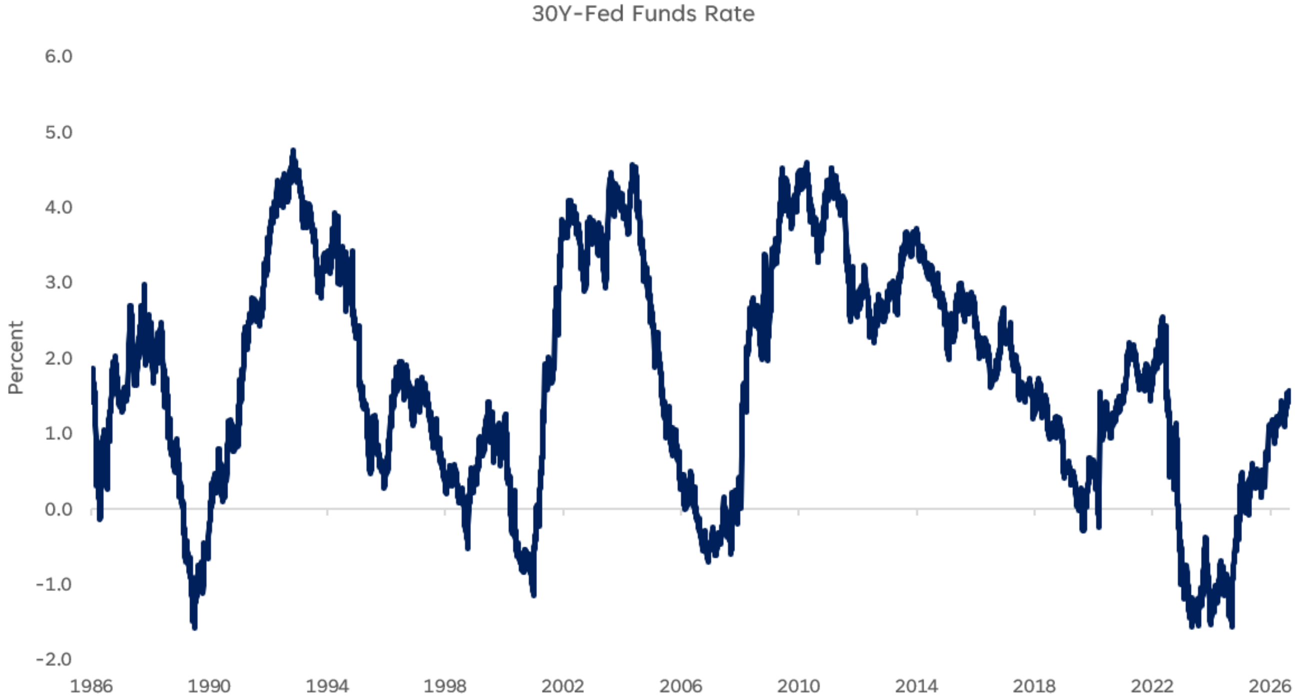
The curve is still not steep
Fed funds to the 30-year is roughly 150 basis points, which is unremarkable by historical standards. The 2s10s curve at 40 basis points remains flat relative to a long-run average closer to 90 basis points. We have exited the deep inversion of the past two years, but we have not arrived anywhere unusual.

Note also where the steepness actually lives. The belly is nearly flat, with only 14 basis points between 2s and 5s. Essentially, all of the term structure's slope sits beyond 10 years. That has direct portfolio consequences, which we will take up later.

Treasury Yield Curve is Still Relatively Flat



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Buybacks, the TGA, and What Official Action Can and Cannot Do

Treasury's response to the backup has been tactical, albeit cloaked in a debt management exercise. Effective September 9 through the November 4 close of the current refunding quarter, the maximum size of liquidity-support buybacks in the 10- to 20-year and 20- to 30-year nominal sectors doubles from $2 billion to at least $4 billion per operation. Officials have left the door open for larger sizes if conditions warrant. The stated rationale is liquidity support in longer-dated off-the-run securities, where offer volumes have been consistently strong but the timing of the announcement was questionable.

The more interesting question is how the operations will be funded. The conventional "Treasury Twist" expectation was that buybacks would be financed with additional bill issuance. That would have left reserves roughly unchanged, or drained them, while shortening the government's effective duration. Recent reporting has pointed instead to a possible draw on the Treasury General Account (TGA). The TGA, the government's operating cash account at the Fed, has been built under Secretary Bessent to roughly $940 billion to $950 billion, well above the prior administration's $550 billion to $600 billion target range. Drawing the TGA to retire long-end paper injects reserves one-for-one. It is the opposite of a sterilized twist.

Two caveats keep this from being a regime change. First, scale. Even at $4 billion an operation, the program is small relative to a multi-trillion-dollar long-end market and relative to the coupon calendar that will keep arriving every month. Second, stock-flow identity. Any sustained lower TGA level eventually requires either higher future issuance or a thinner cash buffer into the next debt-ceiling window, currently mapped to winter 2026 into early 2027. Liquidity support funded from cash is not free. It is a timing choice.

Pushback from a Mentor

Stanley Druckenmiller has called the enlarged buybacks a mistake, and his objection is the one that should be taken seriously. There was no evidence of genuine dysfunction, failed auctions, or balance-sheet seizure when the size increase was announced. In his framing, this is price management dressed as liquidity support, and defending the long bond against fundamentals risks escalating the operations, damaging the two-century credibility of the Treasury market, and substituting political timing for the only remaining fiscal disciplinarian. We noted the timing of the announcement in the same spirit. The initial market reaction had the fingerprints of a short squeeze. Speculative positioning in Treasury futures, particularly among leveraged funds, had reached extremes last seen in the 2018 short build. A catalyst that size, dropped into a one-sided book, produces a 10-basis-point rally in the 30-year whether or not the underlying fiscal arithmetic has changed. It had not.

For markets, the read is Treasury is paying attention to the bond market and likely provides an implicit ceiling on how fast the long end is allowed to run, at least inside a single refunding quarter. It does not address why developed-market yields have been moving higher. Debt and deficit concerns will keep adding volatility to the back end. Yields are not high by pre-2008 standards. Curves are still relatively flat. Even with official support, we think the curve can steepen from here. The larger risk is the one Druckenmiller flagged: repeated tactical support that delays the market’s ability to force fiscal discipline, leaving the long end more vulnerable to a sharper repricing once the political calendar or the cash constraint reasserts itself.

Jackson Hole and Another Confirming Market Signal

At last week’s Jackson Hole Symposium, Chair Warsh said the Fed still has work to do on inflation, emphasizing that interest rates remain the Fed's predominant tool, and noted that better-than-expected recent Consumer Price Index (CPI) and PCE prints do not indicate meaningful improvement in the underlying trend. This was more clarity than markets expected from a chair who had cultivated a reputation for saying little.

The reaction decomposed the curve in real time:

- - 2-year: +12 basis points to 4.356%
- - 10-year: +5 basis points to 4.726%
- - 30-year: +2 basis points to 5.211%

A hawkish surprise moved the front end four times as much as the long end and flattened 2s10s from roughly 44 to 39 basis points. That is exactly what should happen when inflation expectations are anchored and the repricing is concentrated in the expectations component rather than the risk premium. In a market genuinely worried about fiscal debasement, a hawkish central bank is good news for the long end, because it reduces the inflation risk premium embedded there. The long bond barely moved, and unlike previous Warsh press conferences, it did not move against him.

If long-end yields were being driven by an eroding faith in U.S. creditworthiness, a credible inflation-fighting chair would not have produced that response. He would have produced a much larger reaction out of the back end of the curve.

What Would Change Our Mind

A normalization view has to be willing to say when the facts have stopped supporting it. The market would look more like a crisis, and less like a reset, if several things arrived together.

- Coupon auctions that tail in size, with dealer awards above 25% and a clear drop in indirect participation, especially in the seven-year and the 30-year.
- A sustained break higher in the MOVE Index into the triple digits, accompanied by a widening in Treasury-swap spreads that signals dealer balance-sheet stress rather than a level adjustment.

- Breakevens or 5y5y forwards that leave the 2.3% neighborhood and start to reprice a permanently higher inflation regime, which would tell us expectations are no longer anchored.
- Failed or withdrawn official support that reveals the buyback bid as the only thing that had been containing the long end.
- A fiscal event that is larger than the current baseline: a debt-ceiling breach, a sudden jump in issuance needs, or a political choice that markets read as the end of even modest restraint.

The more constructive case on extending duration has its own checklist, and it is equally specific: a downside fiscal surprise that cuts coupon supply, a slowing in AI-related issuance that returns long-duration buyers to Treasuries, a lasting shift in Treasury's issuance mix toward bills, and a run of activity data soft enough to pull the funds-rate path lower without unanchoring inflation. Until one of those two lists starts to fill in, we think we're in this higher-for-longer rate environment that we've talked about for a while now.

The concerns are real. They will keep the long end elevated. They will keep the term premium from collapsing back to the post-quantitative easing (QE) residual. They are not, on the evidence of volatility, auctions, and inflation expectations, a crisis. Yet. A 4% to 5% Treasury market that clears $183 billion in a week and prices one-month volatility below its own average is doing the job a government bond market is supposed to do. It is discovering a price. Income investors should consider that price. Duration speculators may want to wait for a better one.

What Does This Mean for Investors?

If this is the new regime, and we think it is, income investors are the winners. Starting yield explains the overwhelming majority of forward returns in fixed income. Starting yields across the Treasury and high-grade corporate credit complex are the best they have been in twenty years.

Reinvestment risk stops being the threat it was in 2020 and 2021 and becomes the point of the portfolio. A ladder that used to feel like a consolation prize in a zero-rate world is again the correct default architecture for an income investor. Maturities roll off into a 4% to 5% market rather than into a 1% market. The investor is paid to stay patient. The investor is paid to let the calendar work. Credit at these all-in yields does not need spread tightening to deliver an acceptable total return. Carry and roll are doing the work that price appreciation was asked to do when yields were 150 basis points lower. Higher-for-longer is not the risk case for an income portfolio. It is the bull case.

For managed portfolios, we remain neutral relative to benchmark duration. In credit, we prefer to stay up-in-quality and resist the temptation to reach for spreads in a market where AI-related issuance is already filling the index with long, tight, single-name concentration. Agency mortgage-backed securities (MBS) are the relative-value beneficiary if buybacks and a contained 30-year keep rate volatility from breaking out. Securitized sectors (ABS and select CMBS) benefit as well. And for diversification purposes, non-U.S. developed and emerging market debt increases income opportunities.

TIPS belong in the portfolio in case markets are wrong about inflation staying anchored. And while market-implied inflation is anchored, realized inflation is not. Headline PCE at 3.7% and core PCE at 3.3% mean the investor who is long only nominal duration is underwriting a disinflation path the data have not yet delivered. Breakevens near 2.3% are cheap insurance against an inflation surprise. A TIPS allocation does not require a call that inflation is about to re-accelerate. It requires only the admission that the error term around a 2.3% breakeven is not symmetric after five years of above-target prints, a fiscal stance that is not tightening, and an energy complex that has already shown it can put a floor under headlines.

The real yield on long TIPS is itself part of the income argument. Investors can now lock in a clearly positive real coupon and retain the option that CPI runs hotter than the breakeven. That combination did not exist in usable size for most of the 2010s. It exists now.

Bottom Line

The concerns are real. Debt at $40 trillion, deficits above $2 trillion, interest expense compounding against a rate assumption the market has already broken, inflation running near 3.7%, and an unprecedented wave of AI-related duration competing for the same finite pool of long-end buyers. None of that is going away, and we expect yields to grind modestly higher with the steepening concentrated beyond 10 years.

But subdued implied volatility, clean auction mechanics, compressing breakevens, a term premium at half of its long-run average, and a curve that is ordinary by historical standards all describe a market that is repricing risk rather than losing faith. Higher yields are recruiting buyers, which is the definitional test of a functioning market.

We remain neutral duration and continue to wait for the fat pitch. In the meantime, higher for longer is not the risk case for income portfolios. It is the bull case, and the discipline it demands is straightforward: build ladders where the curve pays you, keep credit quality high and take the yield rather than reaching for the spread, and own TIPS as insurance against the one scenario that would prove this framework wrong.

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